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**LATIN AMERICAN AND CARIBBEAN COMPETITION FORUM**

**Session III: Addressing Competition Challenges in Financial Markets**

**-- Contribution from Manuel Sebastião --**

**4-5 April 2017, Managua, Nicaragua**

*This paper by Manuel Sebastião (Non-Executive Director and President of the Audit Committee of REN – Redes Energéticas Nacionais) is circulated to the Latin American and Caribbean Competition Forum FOR DISCUSSION under Session III at its forthcoming meeting to be held on 4-5 April 2017 in Nicaragua.*

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# LATIN AMERICAN AND CARIBBEAN COMPETITION FORUM



15th Latin American and Caribbean Competition Forum  
4-5 APRIL 2017, Managua, Nicaragua

## Session III: Addressing Competition Challenges in Financial Markets

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### COMPETITION CHALLENGES IN FINANCIAL MARKETS

-- CONTRIBUTION FROM MANUEL SEBASTIÃO\* --

#### Abstract

Competition challenges in financial markets are essentially associated with the potential trade-off between competition and financial stability. Since the deregulation of financial markets in the final thirty years of the last century, there is a visible move from the previous “*stability-cum-regulation*” paradigm to the new “*stability-cum-competition*” paradigm. It is true that the financial sector in general and the banking industry in particular are different from other sectors and need regulation. But this is not reason enough to exclude competition advocacy and enforcement from financial markets. Effective measures to deal with this potential trade-off can be framed as the result of a set of appropriate checks and balances—internal and external—for each bank, and *enhanced cooperation* between competition authorities and financial regulators. The recent institutional reforms of financial regulation and supervision in the EU and the UK, although not comparable in terms of ambition and scope, provide a very good illustration of two different approaches on how to establish such *enhanced cooperation*. On the competition enforcement front, the more proactive scrutiny of financial markets and operators by the competition authorities and the heavy sanctions that have been applied in recent years are a healthy warning that the “*stability-cum-competition*” is a new reality that is here to stay.

\* Remarks prepared for the 15th meeting of the OECD-IDB Latin American and Caribbean Competition Forum, Section III: Addressing Competition Challenges in Financial Markets, 4-5 April 2017, Managua, Nicaragua. Manuel Sebastião is a non-executive director and the president of the Audit Committee of REN (the electricity and natural gas transmission system operator of Portugal) and a professor at the Catholic Lisbon School of Business and Economics (Universidade Católica Portuguesa). The views expressed are the author’s own and do not necessarily reflect those of either of these institutions.

## Introduction

1. First of all, I would like to congratulate the organizers of the 15<sup>th</sup> meeting of the OECD-IDB Latin American and Caribbean Competition Forum for having included this issue—addressing competition challenges in financial markets—among the issues to be discussed in this forum. As the background note prepared by the OECD Secretariat and the various country contributions so well illustrate it, the issue is indeed topical.

2. Let me also thank the organizers of the forum for having invited me to be a speaker in this third section. I am grateful for this opportunity, which has given me the incentive to write down a number of ideas that I think are worthy of such a distinguished audience as this one.

3. I am also grateful for the opportunity of interacting again with this great community of competition experts and authorities and bringing back to mind the fond memories I have of the time I was part of such a community.

4. Addressing competition challenges in financial markets is a topical issue for two main reasons. Firstly, because financial markets are so critical for the functioning of modern economies that it is difficult to think that they should not operate on a competitive basis. And secondly, because the long held idea that there is a potential trade-off between financial stability and competition kept financial markets off the radar of competition authorities for many years. This is no longer the case, but to understand why this was and why it should not be so is possibly the best starting point in our quest to know how best to address competition challenges in financial markets.

5. Traditionally, competition concerns were absent from financial sector regulation and policies until the deregulation of the 1970s and 1980s started unravelling the “*stability-cum-regulation*” paradigm that had prevailed since the Great Depression.

6. It is true that the financial sector in general and the banking industry in particular are prone to a number of market failures that need regulation. But this *per se* is not enough to rule out competition on the grounds that there is a potentially adverse trade-off between financial stability and competition.

7. It is therefore important to understand the relationship between stability and competition. In particular, it is important to have clear ideas about two points. Firstly, about the extent to which competition or the lack of it has affected financial regulation and stability; and secondly, how the pros and cons of an exclusive approach – whether stability-exclusive or competition-exclusive – are much better addressed if we adopt a balanced approach based on a different “*stability-cum-competition*” paradigm.

8. According to well established economic theory, as long as standard competition assumptions and principles apply, enhancing effective competition is good in the sense that it is conducive to more and better goods and services at lower prices for consumers, more dynamic and innovative firms, higher productivity growth and more robust and sustainable economic development.

9. Addressing the potential trade-off between stability and competition in banking requires a thorough understanding of a number of realities, in particular:

- i. Barriers to entry, expansion and exit or, more generally, the contestability of financial markets;
- ii. Asymmetric information between the contracting parties and problems of adverse selection and moral hazard;
- iii. Switching costs in moving from one bank to another and associated market power;

- iv. The network effects of interbank activities;
- v. Risk-taking appetite, which may be biased either on the side of too much or too little risk-taking by banks, resulting in the mispricing of risk and/or the mispricing of liabilities;
- vi. The economics of two-sided markets; and
- vii. Consumer protection conduct, especially in retail banking.

10. Regulation in banking as in other regulated industries is necessary to correct market failures but so are clear ideas about which market failures need to be addressed in order to better safeguard financial stability without (hopefully) affecting competition.

11. Recent institutional reforms of financial regulation in the EU and the UK addressed in somewhat different ways this interface between stability and competition: the EU through a number of key provisions in the Banking Union set up; and the UK through the empowerment of financial regulators in terms of fostering and enforcing competition in financial markets.

12. Reforms such as these help us understand how prudential regulation designed to address market failures can affect competition in financial markets either directly or through unintended consequences.

13. In the same vein, if market failures are not well understood and regulation is not well designed, such regulation may have an opportunity cost that can be very high. It is a by-product worth scrutinizing but in general simply overlooked.

14. I organized my talk as follows. Following this introduction, there will be 5 sections. Section 1 summarizes the reasons why banks are special and need regulation. Section 2 discusses a number of ideas on the two major breakdowns in the functioning of banks – banking crises and competition infractions. Sections 3 and 4 address two recent major institutional reforms (with implementation started in 2012-2014), with both attempting to reconcile stability and competition concerns in the banking industry: the creation of *Banking Union* in the European Union; and the reform of financial regulation authorities in the UK. Section 5 provides a brief overview of competition infractions in banking and the heavy sanctions that competition authorities have been applying recently. I will then briefly conclude.

## 1. Why banks are so special and need regulation

15. We know that a bank is the institutional outcome of three basic ideas:

- First, a bank basically does two things: *(i)* maturity transformation – of short-term deposits into longer term loans – and *(ii)* risk management – the most important of which are default and liquidity risks;
- Second, a bank is an intrinsically vulnerable institution. Any bank, even a very well-managed bank, is not immune to a bank run, in which case it cannot survive without outside support; and
- Third, any bank is subject to systemic risk, i.e. risks that originate in other banks but to which any bank is not immune due to contagion effects. Thus, safety issues and risk concerns should be at the core of any banking practice, policy and regulation.

16. We also know that the banking industry is different from any other for a number of reasons, namely:

- i. The fact that banks are instrumental *(i)* in managing and channelling the savings and financial wealth of the economy; *(ii)* in the functioning of the payment system; and *(iii)* the transmission of monetary policy decisions;
- ii. The high level of interconnectedness and interdependence within the financial sector,
- iii. The network set-up of some of its key components, such as the interbank market or the payment system;
- iv. The leverage ratio of its operation, the highest of any economic activity; and
- v. The systemic risk to which it is prone.

17. Banks' features and their differences vis-à-vis other firms concur to require that each bank implements effective internal controls, especially in three areas – operations, risk management, and compliance – focused on detecting in time and ultimately avoiding:

- i. Developments that could lead *(i)* to serious maturity mismatch between illiquid and long-lived assets and liquid and short-lived liabilities; and/or *(ii)* to serious default risk that may pose solvency threats;
- ii. Interbank connections that could generate negative externalities and are most vulnerable to systemic risk and competition infractions; and
- iii. Board and staff incentives and performance evaluation systems that could stimulate excessive risk appetite and/or tendencies for less than strict compliance with sector, competition, and market rules and regulations; and, last but not least;
- iv. Breaches in the trust banks deserve from their clients and/or shortfalls in compliance with the required standards of consumer protection, especially in retail banking.

18. Banks' features and their differences vis-à-vis other firms also concur to make banking a highly regulated and supervised industry. Regulation in banking as in other regulated industries is necessary to correct market failures but so are clear ideas about which market failures need to be addressed in order to better safeguard financial stability.

19. Traditionally, the goal of financial stability was interpreted in a rather narrow sense: to ensure that the bankruptcy of a bank does not affect its depositors and does not imply the bankruptcy of other banks.

20. Also traditionally, at least until the 1980s, when the deregulation of financial markets started in the developed world, the goal of financial stability was insulated from competition concerns because it was assumed that competition would exacerbate the inherent fragilities of the financial sector and accentuate the potentially adverse trade-off between competition and stability.

21. Alternatively, the goal of financial stability could be interpreted in a rather broad sense: to maintain and foster a stable, competitive financial environment capable of attracting the savings and providing the credit that the economy requires and benefiting from the trust of bank stakeholders in general. In such an environment, there is no place for banking crises or speculative bubbles.

22. This broad interpretation has been gaining ground since the 2007-2008 financial crisis, which has led to the increase in competition enforcement actions in banking since then.

23. In short, understanding incentives and externalities as well as identifying, measuring and controlling risks in banking are top priorities for banks, regulators, and sector and competition enforcement agencies. Thus, the need for

- i. Safe and sound banking;
- ii. Safe and secure payment services;
- iii. Fit and proper bank boards and staff members;
- iv. Regulatory and supervision rules and practices, well designed, implemented and monitored; and
- v. The right balance between the maintenance of financial stability through an efficient prudential framework and the fostering of financial competition through appropriate advocacy and enforcement.

## 2. Banking crises and banking competition infractions

24. Fortunately, banking crises and banking competition infractions are not a regular occurrence although they tend to be more frequent in some countries and at certain times. They are the consequence of banks characteristics and specific economic and political circumstances in which banks operate, and it is therefore important to understand which characteristics and/or circumstances are instrumental or even causal in the occurrence of such crises or infractions.

25. Banks' features and their differences vis-à-vis other firms contribute to but are not sufficient conditions for the occurrence of such crises and infractions. In general, banks develop and apply effective ways and means for dealing with liquidity and default risks, interbank linkages, and corporate governance principles and practices that protect them from falling into trouble.

26. However, in emergency or difficult situations, especially when there are economy-wide disturbances, breakdowns may occur. In general, such breakdowns do not occur out of the blue, rather they are the result and the confluence to different degrees of a succession of errors or outright failures – governance, market, regulatory and even economic policy failures.

27. Two basic ideas are relatively consensual today. One is that financial crises do not change the rationale for competition policy, although they change the economic realities in which competition policy works. The other is that while there should be no compromise on competition policy standards, there is a need for flexibility in procedural matters. The reason is simple: the conceptual framework of competition is flexible enough to be adapted in scope, time and focus in order to accommodate the crisis circumstances and the required adjustments.

28. As the 2008 crisis unfolded, public intervention—by governments, central banks, and sectoral regulators and supervisors—became common. The purpose was to face the financial crisis and the ensuing recession (in the USA and in the EU), including major rescues of banks on both sides of the Atlantic, and it was all carried out with the same overarching objective: to ensure financial stability.<sup>1</sup>

29. The reform of the financial sector was one of the responses to the 2008 crisis. Given the origin of the crisis, this was natural; it was the case in both the EU and the U.S.A.

30. Rescues of banks on both sides of the Atlantic were carried out with a major legal difference between the two sides.

31. In the U.S.A., “State aid” depends only on budget appropriations and is decided by the U.S. government (Treasury) and the relevant sectoral agencies<sup>2</sup> with no involvement of the competition authority, the Federal Trade Commission (FTC).

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<sup>1</sup> See Jenny, Frédéric, *The economic and financial crisis, regulation and competition*, OECD Competition Committee, *Competition Issues in the Financial Sector – Key Findings*, 2011; and Nordic Competition Authorities, *Competition Policy and Financial Crisis – Lessons Learned and the Way Forward*, Report No. 1/2009.

<sup>2</sup> Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Commodities Future Trading Commission (CFTC).

32. In the EU, Member States have to comply with the provisions on “State aid” of articles 107, 108 and 109 of the Treaty on the Functioning of the European Union (TFEU),<sup>3</sup> and are subject to the scrutiny, authorization and monitoring of the European Commission (Directorate General for Competition, DG COM).

33. Pursuant to the policy of “State aid” control, the European Commission:

- i. Activated for the first time the provision of article 107(3.b) TFEU, according to which “State aid” is compatible with the European Union (EU) internal market if it is intended “*to remedy a serious disturbance in the economy of a Member State*”;
- ii. Set out specific rules and guidance for intervention in the financial sector through seven *Crisis Communications*; and
- iii. Embarked on the major institutional reform of the *Banking Union*.

## BANKING UNION

34. The *Banking Union* was launched in June 2012, at the bleakest time of the euro crisis and is made up of three components: the first—*Single Supervision Mechanism*, SSM<sup>4</sup>—entered into force in November 2014; the second—*Single Resolution Mechanism*, SRM<sup>5</sup>—entered into force in January 2016; and the third—*Deposit Guarantee Scheme*, DGS—has not yet a definite date to enter into force. Thus, until the DGS component is in place, the EU will make do with an incomplete banking union.

35. Through the SSM and SRM, responsibilities in matters of banking supervision and resolution were transferred from the national level of each Member State to the European level. In this way, the *Banking Union* complements the Economic and Monetary Union (EMU) and deepens the Single Market.

36. The notion of a banking union is the type of great institutional reform that became a reality because EU decision makers realized that they were at the right moment to seek support for measures that might not be acceptable in normal times, hoping that the very EU legislative process will prevent reversals once normal times return.

37. The creation of the *Banking Union* is well explained through the conceptual framework advanced by Calomiris and Haber in their book so correctly entitled *Fragile By Design—The Political Origins of Banking Crises and Scarce Credit*,<sup>6</sup> whose central message is that a “country does not ‘choose’ its banking system: rather it gets a banking system that is consistent with the institutions that govern its distribution of political power.”

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<sup>3</sup> See Treaty on the Functioning of the European Union (TFEU), Title VII on Common Rules, Taxation, and Approximation of Laws, Chapter I on Rules on Competition, Section II on Aids Granted by States: Article 107 on compatibility with internal market; Article 108 on review; and Article 109 on power to adopt regulations.

<sup>4</sup> Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

<sup>5</sup> Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.

<sup>6</sup> See Charles Calomiris and Stephen Haber, *Fragile By Design—The Political Origins of Banking Crises and Scarce Credit*, Princeton University Press, 2014.



38. By political power those authors mean “the way the fundamental *political institutions* of a society structure the *incentives* of politicians, bankers, bank shareholders, depositors, debtors, and taxpayers to form *coalitions* in order to *shape laws, policies, and regulations* in their favor—often at the expense of everyone else.”

39. The financial sector institutional reform in Europe also includes since 2014 the upgrade of three sectoral committees to three powerful, fully-fledged regulation authorities: the European Banking Authority (EBA), the European Securities Market Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). These authorities are the financial regulators of the European Union.

40. The new set-up of the *Banking Union* introduced a profound reform of banking supervision and resolution in Europe including (i) the transfer to the European System of Central Banks (Eurosystem) under the aegis of the European Central Bank (ECB) of new and enlarged powers of regulation and supervision, especially the power of authorizing and revocating a bank’s charter; and (ii) the strengthening of the powers of the Directorate General of Competition of the European Union, DGCOM, in the approval or not of the restructuring plans of banks

41. The *Banking Union*, as far as its banking restructuring and resolution components are concerned, is built on three pillars: viability, burden-sharing and competition.

42. The viability pillar aims at contributing to restore long-term financial sustainability of the banks without the need for “State aid” after restructuring or, if this is not possible, orderly resolution. With the entry into force of the Single Resolution Mechanism, “State aid” for restructuring is no longer possible.

43. The burden-sharing pillar aims at minimizing the cost of “State aid” and mitigating moral hazard. The basic idea is that bank stakeholders have to contribute to its restructuring or resolution, thus eliminating or reducing the costs to be supported by the taxpayer. “Bail-in,” rather than “bail-out” became the key word in bank restructuring and resolution. And if the stakeholders are not sufficient to absorb all the losses, the other banks of the system are called on to foot the bill through their contributions to the Resolution Fund. In this way, the very competitors of the bank subject to a measure of resolution may have to provide last resort financing, non-refundable, i.e. the “competitors’ backstop.” In this case, the competitors are not called on to play the role of “*lenders of last resort*” but to become the “*losers of last resort*.”

44. The competition pillar aims at minimizing competition distortions as a result of “State aid” so that there is no reason for competition policy, advocacy and enforcement to deviate from the norm.

45. These three pillars frame the *Banking Union’s* three basic principles on the restructuring or resolution of a bank:

- i. No bail-out, therefore no fiscal backstop (no taxpayer money);
- ii. Mandatory bail-in; and
- iii. Competitors’ backstop: if needed, last resort financing, non-refundable, of a bank’s bankruptcy costs by the other banks of the system, the “losers of last resort.”

46. The three principles are at the core of the *Banking Union* paradigm change, expressed more simply as the move “*from bail-out to bail-in–cum-competitors’ backstop.*” This paradigm change is internally coherent but deserves close scrutiny in terms of adherence to reality and additional costs of litigation and restitution. In fact, it raises a number of questions whose answer is not linear at all.<sup>7</sup> Let me leave you with only one for which I will refrain from providing any answer: *Is it true that “State aid” distorts competition, so no bail-out; but the competitors’ backstop, i.e. last resort financing, non-refundable by competitors, does not distort competition?*

#### **4. The UK competition concerns in financial regulation**

47. The adoption of the Financial Services Act 2012 in the UK brought significant changes in terms of the authorities in charge of the regulation of financial services and of the remit and powers of these authorities as far as competition in financial services is concerned.<sup>8</sup>

48. The authorities assigned with responsibilities in the regulation of financial services are the Prudential Regulation Authority (PRA), the Financial Conduct Authority (FCA), and the Payment Systems Regulator (PSR), which is a subsidiary of the FCA.

49. The PRA, besides its primary objectives of promoting the safety and soundness of financial institutions and securing protection for insurance policy holders, was subsequently given a secondary competition objective (SCO).

50. The SCO states that the PRA should fulfil its functions according to its primary objectives and in the process safeguard and foster, as reasonably and as proportionately as possible, effective competition in the financial markets where PRA-authorized economic agents operate.

51. However, the PRA has no competition enforcement powers, which were given to concurrent regulators whose remit covers financial services, namely the Competition and Markets Authority (CMA), the UK’s primary competition and consumer agency, the FCA and the PSR.

52. As a result, the PRA has competition powers complementary to, but distinct from those of the CMA, the FCA and the PSR, all of which have enforcement powers within the UK’s competition law. The FCA and PSR also have powers to conduct market studies and market investigations related to the provision of financial and payment services.

53. Thus, PRA’s SCO together with FCA and PSR competition enforcement powers are the components of the UK institutional reform, whose aim is to bring competition concerns into financial prudential regulation.

54. The approach to the SCO was already the subject of the first *ex-post* evaluation and in March 2016, exactly two years to the month after its implementation, two documents were published (*i*) the evaluation report by the Independent Evaluation Office and (*ii*) the PRA’s response to that report.<sup>9</sup> This

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<sup>7</sup> For some other questions see Manuel Sebastião, “*Banking Union: the quest for a new financial regulation paradigm,*” remarks at the seminar “*Banking Union: The new Frontier of Financial Regulation in the European Union,*” 25-26 January 2016, Catholic Lisbon School of Business & Economics, Lisbon, Portugal.

<sup>8</sup> See “The Prudential Regulation Authority’s secondary competition objective,” *Bank of England Quarterly Bulletin*, 2015 Q4, pp. 334-343.

<sup>9</sup> See “*Evaluating the PRA’s approach to its Secondary Competition Objective,*” Bank Evaluation Office, Bank of England, March 2016, and “*The PRA’s response to the Independent Evaluation Office’s*

fact says much about the commitment and effectiveness of the UK reform to deal with the potential trade-off between stability and competition.

## 5. Competition infractions and sanctions

55. According to John M. Connor,<sup>10</sup> in the period from 1990 to January 2014, competition infractions in banking worldwide:

- i. Totalled 412 infractions;
- ii. Most infractions were on classic price fixing (81%), followed by conspiracies to misrepresent benchmark price indices (10%), commodities market price manipulation (5%) and bid-rigging (3%);
- iii. The total amount of fines reached USD 26 billion.

56. According to the Deloitte Center for Financial Services<sup>11</sup> enforcement actions in banking show a new reality where:

- i. The number and severity of enforcement actions are stabilizing at historical levels and fines have increased markedly since 2010;
- ii. The composition of enforcement actions reflects differences in supervisory agencies;
- iii. Supervisors are expected to remain aggressive in their sanctions and expand the types and issues they will proactively pursue.

57. According to D. Scheld, J. Paha, and N. Fandrey,<sup>12</sup> banks pay close attention to compliance in order to prevent financial crime, money laundering, and corruption but they should pay at least equal attention to managing antitrust risk.

58. More recently, in July 2016, the Bundeskartellamt declared illegal the rules imposed by the German Banking Industry Committee on online banking customers who cannot use their personal security features PIN (personal identification number) and TAN (transfer authentication number) in non-bank payment systems to allow access to third party systems, which include the so-called payment initiation services. According to the German regulator, these rules imposed for security reasons “*cannot be considered as a necessary part of a consistent security concept of banks and they impede non-bank competitors.*”

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*evaluation of the PRA’s approach to its secondary competition objective.*” Prudential Regulation Authority, Bank of England, March 2016.

<sup>10</sup> John M. Connor, “Big bad banks: bid rigging and multilateral market manipulation,” *Annual Proceedings of the Fordham Competition Law Institute 2015*, pp. 213-250.

<sup>11</sup> Research report from the Deloitte Center for Financial Services, “*Enforcement Actions in the banking industry – Trends and lessons learned.*” 2015, Deloitte University Press.

<sup>12</sup> Denise Scheld, Johannes Paha, and Nicolas Fandrey, “Managing antitrust risks in the banking industry,” *European Competition Journal*, 2016, Vol.12, No. 1, 113-136.

59. Even more recently, in December 2016, the EU DGCOM and the Swiss Competition Authority (COMCO) fined several banks for colluding to manipulate the price of interest rate derivatives. Three banks<sup>13</sup> were fined by DGCOM for a total of USD 520 million, which raised the total amount of fines imposed on banks by the EU in the three-year period 2014-2016 to some EUR 2 billion. Eight banks<sup>14</sup> were fined by COMCO for a total of CHF 99 (USD 96 million).

60. The Bundeskartellamt decision focused on the electronic retail payment system. Mainly in Europe, there has been a number of enforcement actions against payment service providers, especially four-party credit card schemes such as VISA and MasterCard. And the EU has implemented a regulatory approach whose most important elements are the pricing provisions of two EU Regulations and the new Payment Services Directive 2 (PSD2).

61. The pricing provisions are the following: (i) a zero MIF for SEPA<sup>15</sup> cross-border direct debits, in force since November 2012, coupled with a non-zero MIF for corresponding R-transactions;<sup>16</sup> and (ii) the price caps on MIFs for SEPA payment cards: a maximum interchange fee of 0.2% for a debit transaction and of 0.3% for a credit transaction in full force since June 2016.<sup>17</sup>

62. Price regulations, unless they rightly address the market failures they are supposed to correct, have distorting effects on market outcomes. If a regulated price is zero and the corresponding shadow price is non-zero, the equilibrium between supply and demand is affected. In the same vein, if two price caps are simultaneously introduced, one on a risky service (credit transaction) and the other on an associated risk-free service (debit transaction), at least one of those caps is unlikely to be right: if 0.2% is right for a debit transaction, 0.3% for a credit transaction is insufficient to price correctly the risk premium, i.e. the cost differential of a credit transaction vis-à-vis a debit transaction in terms of risk and providing payment guarantee and a free funding period; and if 0.3% is right for a credit transaction, 0.2% for a debit transaction is excessive for the same reasons.

63. In other words, this price regulation may have three distorting effects: (i) the price level distortion, as a result of administratively setting price levels, unless these prices fully correct the market failures which are at stake; (ii) the rate of change distortion, if regulated prices simply do not change or they change in such a way that they do not accompany the change in market conditions; and (iii) the relative price distortion, as a result of automatically setting the relative price of credit and debit transactions, once these two prices have been administratively set simultaneously.

64. Price regulations may have an additional effect: they may generate opportunity costs. A good example is the following. There are only two economies where international credit card schemes other than the American brands saw the light of day and have been expanding ever since: China and Japan. In contrast with these two economies, the EU has not developed its own card scheme, which would be the most visible and instrumental component of a great pan-European electronic retail payment system, in spite of having

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<sup>13</sup> JP Morgan Chase, HSBC, and Crédit Agricole.

<sup>14</sup> Credit Suisse, UBS, Deutsche Bank, Citigroup, JP Morgan Chase, Barclays, RBS, and Société Générale.

<sup>15</sup> SEPA stands for Single Euro Payments Area.

<sup>16</sup> See *Regulation (EU) 260/2012 of the European Parliament and of the Council of 14 March 2012 establishing technical and business requirements for credit transfers and direct debits in euro and amending Regulation (EC) No 924/2009*. R-transactions are those which cannot be properly executed or result in exceptional processing. The letter “R” can signify reject, refusal, return, reversal, revocation or request for cancellation.

<sup>17</sup> See *Regulation 2015/71 of the European Parliament and of the Council of 29 April 2015 on interchange fees for card-based payment transactions*.

the expertise, the experience and the scale to do so. Two questions are obvious. First, why has it not happened so far? And second, why will it not happen in the foreseeable future? For sure, the answers have much to do with price and non-price regulation.

65. The PSD2 will enter into force in January 2018 and will replace the previous Payment Services Directive (PSD) in force since November 2009. It is intended to accomplish three objectives: (i) to extend the scope of PSD to new services and players, currencies and geographies; (ii) to reduce entry barriers to new payment service providers and online account information service providers; and (iii) to provide more legal certainty in order to enhance customer protection and improve transparency. The ultimate goal is to drive competition and foster innovation while making payments more secure with customers having to provide two pieces of secret information, the so-called “strong authentication,” for the transaction to take place.

## 6. Conclusions

66. The issues we have discussed previously and the challenges they raise deserve our best attention. It is true that the financial sector in general and the banking industry in particular are different from other sectors and need regulation. But this is not reason enough to exclude competition advocacy and enforcement from financial markets.

67. Competition advocacy and enforcement are instrumental in addressing market failures such as prohibited practices, abuse of dominance or mergers that have the potential to undermine competition in financial markets. And they can also contribute, particularly in crisis situation, to prevent today’s solutions from becoming tomorrow’s problems.

68. As with all human endeavours, however, sector regulation and competition advocacy and enforcement of financial markets are not perfect. But as long as they contribute to make financial markets more stable and competitive, the potentially adverse trade-off between stability and competition keeps moving in the direction of a twin-objectives agenda of stability and competition.

69. Effective measures to deal with this potential trade-off can be framed as the result of a set of appropriate checks and balances – internal and external – for each bank. Internal checks and balances are best provided by corporate governance principles and best practices. External checks and balances are best provided by well-designed and balanced sector regulation and supervision and effective competition advocacy and enforcement, put in practice by *enhanced cooperation* between competition authorities and financial regulators.

70. With such checks and balances in place, the move from the “*stability-cum-regulation*” paradigm to the “*stability-cum-competition*” paradigm is more and more feasible.

71. The institutional reforms of financial regulation and supervision in the EU and the UK may not be comparable in terms of ambition and scope, but they provide a very good illustration of two different approaches on how to reconcile stability and competition concerns in banking. Furthermore, with Brexit, the EU reform will not apply to the UK and the two reforms will have a life of their own without interfering with each other.

72. The EU reform is mainly concerned with distortions to competition as a result of “State aid” and with the paradigm change “*from bail-out to bail-in-cum-competitors’ backstop.*”

73. The UK reform is concerned with setting a secondary competition objective (SCO) to one of the financial regulators and giving to two other financial regulators competition powers in relation to the enforcement of UK competition law. And just two years after implementation of the reform, the first ex-post evaluation of the approach to the SCO was concluded with positive recommendations.

74. In short, the EU reform is a heavy institutional reform *(i)* rules-based, *(ii)* involving the centralization of supervision and resolution powers, the upgrade of three sectoral committees to three regulation authorities, and the strengthening of DGCOM powers in matters of restructuring and resolution of banks, and *(iii)* with competition concerns as a by-product of a paradigm change. The UK reform is a much lighter institutional reform *(i)* principles-based, *(ii)* involving the setting of competition objectives and the competition empowerment of financial regulators, and *(iii)* with competition concerns as a direct objective of the reform.

75. On the competition enforcement front, the more proactive scrutiny of financial markets and operators by the competition authorities and the heavy sanctions that have been applied are a healthy warning that the “*stability-cum-competition*” is a new reality that is here to stay.

76. Finally, addressing competition concerns with price regulation is a very difficult exercise because there is often the possibility of mispricing the goods and services whose prices are regulated. From a legal point of view, regulation provides a safe harbour for undertakings which comply. But from an economic point of view, if regulation stifles the incentives to invest (or to cooperate on economy-wide structuring endeavours), the opportunity cost of not doing something that society as a whole would greatly value could be very high. Such opportunity costs should not be overlooked.

77. In conclusion, the ideas that we keep discussing in fora like this one on such topical issues as competition challenges in financial markets are an excellent testimony that competition advocacy and enforcement are as lively and as daring as we all want them to be, so market outcomes and the welfare of consumers are very likely to be much better tomorrow than they are today.